DLF
ATTORNEYS-AT-LAW

Legal due diligence of companies in Ukraine

B

Successful investing does not begin with a deal, but with a deep understanding of what you are dealing with (pun semi-intended). Luring asset prices are appealing, but behind a "good" price may lie a number of legal pitfalls that could devalue or even destroy your investment. That is why a legal audit is not a mere formality, it is a prerequisite for safely entering into business, acquiring assets or concluding transactions in Ukraine.

1. Privatised enterprises and property

In the early 1990s, all production assets and land belonged to the state. The process of transferring such assets into private ownership is still ongoing. Most companies with a long history own such assets in one way or another.

The privatisation process has created a lot of space for errors in documents and procedures, which can lead to lengthy and costly litigation. Imagine the following scenario: a company that was leasing premises purchased them from the local community without auction on terms of a buyout. The sale and purchase agreement, the relevant council resolution and the entries in the property registers were all duly executed. However, at the time of concluding the agreement, the company did not have sufficient evidence that the necessary improvements to the premises in the amount required for this type of acquisition had been made. This became the ground for a lawsuit filed by the local prosecutor. The court concluded that the company had no right to acquire this property without an auction and declared the sale and purchase agreement invalid.

Related article: Legal Due Diligence in Ukraine: uncovering risks

Obligations arising from the terms of privatisation can also be a source of risk. In some cases, such conditions include, for instance, the preservation of the company's core business.

If an investor acquires control over such a company, they will not be able to change its domain, say by converting the production premises of a former bakery into a car service centre. Such encumbrances are not usually reflected in registers or title documents for property – but rather are contained exclusively in privatisation documents.

To identify such risks, it is necessary to study the grounds for acquiring ownership. If the grounds are privatisation documents, it is necessary to find out exactly what procedure was used to transfer the property. It is also important to check:

- compliance of the procedures with the legal requirements in force at the time of ownership acquisition;
- the existence of any additional obligations, such as retention of jobs, main activity type, etc.

2. Corporate history

Examining a company's corporate history is even more important than establishing its current legal status. Failure to comply with legal requirements when acquiring shares or stocks may result in the invalidation of agreements between previous and current owners. As a result, the investor's ownership of the company may be called into question.

Situations where previous owners have not paid their shares in full, have not obtained the consent of their spouses to sell, or have not followed the procedure for the transfer of shares stipulated in the articles of association are not uncommon. In such cases, there is a risk that all subsequent decisions of the current owner, including the acquisition of the company by the investor, will be invalidated. This may lead to the loss of control over the asset in question.

Related article: How to effectively perform Legal Due Diligence in Ukraine

To identify such risks, it is necessary to examine all versions of the company's statutory documents from the moment of its creation. Particular attention should be paid to establishing the circumstances under which the current owners became participants, if they are not the founders. In such cases, it is worth analysing all documents that served as the basis for their acquisition of corporate rights, in particular:

- a spousal consent;
- powers of attorney;
- resolutions of authorised bodies;
- compliance of procedures with the formal requirements of the charter;
- full settlement under the agreements, etc.

It is important to take into account the legislation and editions of corporate documents in force at the time of conclusion of the relevant agreements.

In the case of a joint-stock company, it is necessary to go beyond the records in the registers and examine the agreements based on which the shares were acquired. Among other things, the following should be checked:

- compliance with the conditions for the acquisition of a significant batch of

shares;
- ensuring the pre-emptive rights of other shareholders;
- compliance of the forms of securities with the legislation and the company's charter in force at the time of conclusion of the agreements, etc.

Situations where there have been cases of withdrawal or exclusion of participants in the company's history pose a particular threat. In the event of a participant's exclusion, the procedure must be followed with particular precision in accordance with the legislation and charter in force at the time. If this is not done, the former participant may demand restoration of rights or compensation, and if successful, appeal the decision to sell the company and regain co-owner status.

To verify such risks, it is necessary to analyse:

- all editions of the statutory documents since the company's establishment;
- all minutes of the authorised bodies with continuous numbering;
- all documents related to the withdrawal or exclusion of participants;
- confirmation of the sending and receipt of notifications;
- making the appropriate payments, signing acts of transfer of property, etc.

The issue of dividend payments in such companies should not be ignored either.

A participant who owns a share at the time of the resolution on the profit distribution is entitled to receive dividends. Failure to pay them within the deadline specified by law or the founding documents is a breach of a monetary obligation. This gives grounds for a claim for compulsory collection of the debt, taking into account inflation losses and penalties.

If there is profit, especially undistributed profit, it is necessary to study all the minutes of the general meeting regarding decisions on payment or non-payment of dividends, as well as confirmation of the payments: payment documents or cash orders.

3. Property acquired via auctions

The legal status of property acquired through auction is inextricably linked to the procedures for preparing and conducting auctions. In cases where such procedures are violated, there is an increased risk of them being declared invalid, which may result in the auction results being cancelled. This may lead to the loss of rights to the property in question.

Related article: Legal due diligence of Ukrainian agricultural assets

For instance, a company purchased a production facility at an auction as part of enforcement proceedings. One of the auction participants challenged the results of the auction, citing violations committed during the auction and the fact that the price offered did not comply with the established rules. The court invalidated the auction and, thus, cancelled the sale and purchase agreement.

To prevent such situations, it is important to:

- check the basis for the property ownership;
- analyse the auction protocol and ensure that it complies with the legislative

requirements in force at the time;
- analyse compliance with the procedure for informing participants, determining their composition, setting the starting price, and the methods for increasing bids;
- establish compliance with the procedure for signing documents after the auction, etc.

Any violations may be used as grounds for challenging the rights to the acquired property.

4. Specifics of infrastructure use

When conducting a legal due diligence of a company, special attention should be paid to infrastructure facilities that support its production activities. This includes, in particular, the supply of energy resources, accessibility of entry roads, railway tracks, communications, and other facilities without which the normal functioning of the company is impossible.

Related article: Legal Due Diligence of renewable energy projects in Ukraine

Loss of control over such facilities may completely halt operations and lead to asset depreciation.

For example, the access road to the elevator gate may pass through the territory of another enterprise. Any restriction of access, even temporary, causes additional costs for relocation of weighing stations, checkpoints, and changes in logistics. If the right to use such territory is not properly formalised, access to infrastructure may be blocked in the event of a change in ownership of the adjacent enterprise, especially if it is a competitor.

To prevent such risks, it is essential to check all communications used in the production process: access roads, gas pipelines, electrical substations, cables, water pipes, etc. It is essential to verify whether the company has duly registered rights to use these facilities, in particular:

- lease agreements, easements, acceptance and transfer acts;
- technical conditions, permits that comply with the requirements of the effective legislation.

It is also necessary to assess the stability of such rights and the possible risks of their termination or restriction in the future.

5. Loans

One of the often-underestimated sources of risk when entering into agreements with companies is the terms of existing loan agreements. Many of them contain provisions on change of control, which is interpreted as a negative event giving the creditor the right to demand early debt repayment.

The obligation to notify the creditor of such changes usually arises after they have actually taken place, but failure to comply with this obligation may be considered a breach, resulting in financial penalties or, in the worst case, technical default. Such a default often triggers cross-default provisions in other loan agreements that the company has entered into previously. This triggers a cascade of risks that can destabilise the company's financial position even in the absence of actual liquidity problems.

To minimise these risks, due diligence must include a detailed analysis of all the company's loan agreements, regardless of their value. The following should be examined:

- the amount of liabilities;
- repayment schedules;
- provisions on change of control;
- requirements to notify the creditor;
- penalties for breach of terms;
- the existence of cross-defaults and collateral obligations;
- the validity of agreements and potential timeframes for revision of terms;
- the impact of structural changes in the company on the performance of such agreements.

6. Violations of antitrust legislation

Another risk that may have significant financial consequences for the company is violation of antitrust legislation. In particular, failure to obtain prior clearance from the Antimonopoly Committee of Ukraine in cases where such clearance is mandatory may result in the imposition of a significant fine.

In addition, the absence of the necessary permission from the antitrust authority may serve as grounds for invalidating the creation or acquisition of a company at the request of an interested party. This entails not only legal uncertainty, but also the potential loss of an asset or the need to compensate for losses.

Given the above, during due diligence, it is necessary to check all agreements on acquisition of corporate rights or creation of joint ventures for the presence or absence of the Antimonopoly Committee's clearance. It is also important to verify whether there was any obligation to obtain such clearance under the control criteria, financial thresholds and the presence of related parties.

7. Other risks

During due diligence of a company, other risks may be identified that are not among the most common but may have a significant impact on the value or legal status of an asset. These include:

- the absence or expiry of important licences and permits necessary for conducting business activities;
- arrears in salary or compensation to employees;
- significant liability to the company's management;
- significant influence of related parties;
- quality of financial reporting;
- deficiencies in contracts with counterparties;
- unresolved legal or administrative disputes involving the company or its property;
- criminal cases against the company's management;
- violations related to intellectual property rights, etc.

8. Unfair use of due diligence results

A legal due diligence is also conducted in cases where the current owner is preparing to sell the company or is considering raising funds. In such situations, the results of the legal due diligence may be disclosed to third parties, including potential buyers or lenders. However, such openness sometimes creates risks associated with the misuse of the information provided.

In practice, there are cases when an investor, by prior agreement with an interested party, orders legal due diligence of a company with the intention of selling it. After reviewing the results of the due diligence, which reveal certain weaknesses in the corporate structure, the potential buyer withdraws from the deal. Subsequently, having gained access to confidential information, the party uses it to initiate aggressive actions that may lead to the loss of control over the company.

In such cases, it is advisable to use legal protection tools, in particular, non-disclosure agreements, restrictions on the further use of information and the establishment of liability for unfair actions.